



City Treasurer's Office

7447 E. Indian School Rd, Suite 210
Scottsdale, AZ 85251

PHONE 480-312-2364
FAX 480-312-7897
WEB www.ScottsdaleAZ.gov

Date: February 10, 2015
To: Honorable Mayor and City Council
CC: Fritz Behring, City Manager
From: Jeff Nichols, City Treasurer
Subject: Tax Exemption on Retail Sales of Food for Home Consumption

The City has adopted the Model City Tax Code. The Model City Tax Code was implemented to establish more uniform taxation across various Arizona cities. In 2013 the Model City Tax Code was changed to have a separate sales tax category for retail sales for food for home consumption. In 2013 the City incorporated this new tax category into Section 462 (Retail Sales: food for home consumption) of the City's Tax Code.

Prior to this change, if the City wanted to enact a different retail sales tax rate specific to the sale of food for home consumption, the City would have been required to petition the Municipal Tax Code Commission (MTCC), which consists of 10 Mayors/Councilmembers as appointed by the Legislature. However, as a result of the Model City Tax Code change in 2013 adjusting the rate to another lower rate no longer requires the approval of the MTCC, provided no other changes are required. The City would however need to advise the MTCC and the Arizona Department of Revenue (ADOR) of changes made.

The City's privilege (sales) tax rate is currently 1.65% for all retail sales, which has been effective since July 1, 2004. The Scottsdale Tax Code currently taxes the retail sales of food for home consumption at the same rate it taxes other retail sales. Of the 22 Phoenix metropolitan area cities and towns, 20 of the 22 or 91% have chosen to impose tax on food for home consumption. The average tax rate of the 20 valley municipalities is 2.3%. Of the 92 Arizona cities and towns, 69 or 75% impose a tax on food.

All of the cities in the valley tax food for home consumption with the exception of Mesa and Surprise. The tax rates on food for home consumption for these valley cities are as follows:

Apache Junction - 2.2%	Gilbert - 1.5%	Phoenix - 1.0% *
Avondale - 2.5%	Glendale - 2.5%	Queen Creek - 2.25%
Buckeye - 3.0%	Goodyear - 2.0%	Tempe - 1.8%
Carefree - 2.0%	Guadalupe - 4.0%	Tolleson - 2.5%
Cave Creek - 3.0%	Litchfield Park - 2.8%	Youngtown - 3.0%
Chandler - 1.5%	Paradise Valley - 2.5%	
Fountain Hills - 2.6%	Peoria - 1.6%	

* Phoenix is considering the final phase out of their tax on food for home consumption in March 2015.

Several options could be considered to entirely or partially exempt tax on food for home consumption, including the following:

1. Reduce the rate of the City's tax on food for home consumption.
2. Exempt the City's tax on food for home consumption in its entirety.
3. Enact a special tax rebate program.
4. Request approval of the MTCC to expand allowable retail privilege (sales) tax exemptions related to the purchase of food for home consumption.

This memo will focus on City Council's direction given January 13, 2015 during the 'Define Capital and Operating Budget Parameters Proposed Fiscal Year 2015/16' discussion to phase out entirely the City's tax on food for home consumption.

The City's current sales tax rate of 1.65% consists of 1.00% for the General Fund, 0.35% for the McDowell Sonoran Preserve, 0.20% for Transportation, and 0.10% for Public Safety. For FY 2015/16, the estimated City privilege (sales) tax collected on food for home consumption is \$11.8 million. This represents approximately 7.2% of the total tax collections for the 2015/16 fiscal year. The General Fund portion (including the dedicated Public Safety Sales Tax) is \$7.9 million. The Transportation Fund portion is \$1.4 million and \$2.5 million for the McDowell Sonoran Preserve.

Table 1 below summarizes the revenue impact if the tax on food for home consumption was repealed in its entirety and phased out over three fiscal years.

Table 1

Food Tax	FY 2015/16	FY 2016/17	FY 2017/18
General Fund - 1.00%	(\$2,431,660)	(\$4,924,112)	(\$7,514,009)
Public Safety GF - 0.10%	(236,014)	(477,928)	(751,400)
Preservation - 0.20%	(472,027)	(955,856)	(1,502,799)
Preservation - 0.15%	(354,020)	(716,891)	(1,127,099)
Transportation - 0.20%	(472,027)	(955,856)	(1,502,799)
Total	(\$3,965,749)	(\$8,030,642)	(\$12,398,106)

If City Council wanted to make this a revenue neutral policy decision, Council could consider a sales tax increase on retail sales to offset the revenue impact of eliminating the sales tax on food for home consumption. To fully offset the revenue impact, a sales tax increase of approximately 0.13% (from 1.65% to 1.78%) across the board for all sales tax categories would be necessary. Any increase to the City's sales tax would require voter approval.

If the City wanted to enact a different retail sale tax rate specific to the sale of food for home consumption, the following implementation issues should be considered.

- Prior to such possible consideration, the business community should be presented the proposal for their feedback. Prior to 1987, the business community and the Arizona Legislature voiced concerns regarding the non-standard and varying privilege/use tax ordinances and practices among Arizona municipalities. The purpose of the MTCC, as created through the State Legislature, is to ensure continued uniformity of the Model City Tax Code (as adopted by the City in 1987). Currently, there are only 6 known municipalities that have 2-tier tax rates (one rate for food and another rate for non-food retail items):

	Non-Food	Food
Carefree	3.0%	2.0%
Glendale	2.9%	2.5%
Goodyear	2.5%	2.0%
Patagonia	3.0%	2.5%
Phoenix	2.0%	1.0%
South Tucson	4.5%	1.5%

- Businesses would be required to reprogram their sales systems to charge and account for the differential rate on food sales vs. the 1.65% rate for other retail sales. This will add to the administrative costs for business owners and consumers would likely shoulder the additional costs. There are 177 business licenses in the food category, 38 in the convenience stores (with gas), and 26 in the major department stores all of which sell food for home consumption. Additionally, there are 4,969 business licenses in the miscellaneous retail category. While, staff is

unable to determine how many of those miscellaneous retail licenses sell food for home consumption, it is safe to assume some do sell food for home consumption and would be impacted.

- Accurate reporting by businesses could be jeopardized because of being required to show food for home consumption sales under a separate rate on their tax return. Experience by the City's Tax Audit department shows when differential rates are used because of grandfathering of new tax rates or the difference between the use tax rate and the privilege (sales) tax rate, then accurate tax reporting may be compromised. Other cities have experienced these same concerns.
- Additional City administrative costs will occur if the tax rate were to be lowered (phased out over time), as the City would need to reformat the tax returns to add an additional line item for the specific rate for food for home consumption and changes to the City's database would be required. Beginning in 2016, ADOR will be collecting state and municipal transaction privilege (sales) taxes and affiliated excise taxes. Therefore, if a phased out approach were to occur, it is unclear what ramifications, if any, could result with ADOR. In the interim, the City would need to account for this specific type of revenue. Currently, except for use tax, no other tax classifications (i.e. construction, rental, restaurants, utilities, etc.) have any differential rate from the current 1.65% tax rate. The estimated cost for the necessary reprogramming and staff time ranges from \$15,000 to \$30,000.
- The City's ability to purchase preserve land and/or the ability to pay debt service on existing issued debt for previous land purchases could be impacted by the elimination of sales tax on food for home consumption.
- The food tax is one of the City's most stable excise tax revenues, which by their very nature are elastic. The rating agencies favor stable revenue sources; therefore, eliminating the food tax may have a negative impact on the City's bond rating.
- The City utilizes the Municipal Property Corporation (MPC) to issue bonds on behalf of the City. A portion of the pledged revenues used to pay the debt service payments (principal and interest) on these bonds include the City's General Fund sales and use tax collections. Other significant pledged revenues include state-shared sales tax and income tax collections (but do not include property taxes).

When issuing MPC bonds, the City covenants that the revenues pledged to pay the debt service on the MPC bonds will be equal to at least 3 times the total amount of annual debt service due. If the pledged revenues ever drop below that level, the City is to use its best efforts to either impose/increase additional pledged revenues or to increase tax rates (as the City's sales and use tax rate already exceeds 1.00%, any increase in that rate would have to be approved by the voters). In FY 2013/14, the pledged revenues amounted to \$183 million and existing annual debt service payments are \$40.4 million resulting in a coverage ratio of 4.5 times (\$183 million / \$40.4 million). Debt service payments will increase through FY2019/20 reaching \$49.6 million (at which time the coverage ratio would drop to 3.7 times) before the annual debt service payments start to decrease.

A second covenant involves the ability to issue future MPC bonds. In order to issue future MPC bonds, there is a requirement that the pledged revenues be at least 3 times the principal and interest payments of the already outstanding MPC bonds.

If pledged revenues drop below \$150 million, the coverage ratio would drop below 3.00 times (\$150 million / \$50 million) and the City would need to use its best efforts to increase the pledged revenues and the City would not be able to issue future MPC bonds until revenues increase or principal and interest payments on the bonds decrease.

Erosion of any of the pledged revenues (such as through a reduction or removal of taxes on food for home consumption, rental taxes, construction taxes, state-shared distributions etc.), could result in the City needing to increase the pledged revenues and would also impede the City's ability to issue future MPC bonds.

The Council's current policy is to tax food for home consumption and repealing the tax entirely or partially would be a change in policy. Phasing out and ultimately repealing the City privilege (sales) tax on food for home consumption will lessen the tax burden of all citizens, especially those with lower incomes. However, in doing so, there will be City budget and administrative impacts.

Tax Exemption on Retail Sales of Food for Home Consumption

City Council
February 24, 2015

Food for Home Consumption

- Represents those packaged items purchased from a retail vendor such as bread, milk, soda, crackers, meat, etc.
- Does not include alcoholic beverages or tobacco

Model City Tax Code

- Establishes a more uniform taxation system for Arizona cities
- Allows cities to have a separate sales tax category for retail sales for food for home consumption

Other Governmental Entities

- State of Arizona: Does not tax food for home consumption
- Maricopa County: Does not tax food for home consumption
- Valley Cities
 - 20 of 22 (91%) valley cities tax food for home consumption
 - *Exceptions Mesa and Surprise*
 - *Phoenix considering the final phase out in March 2015*

Tax Rates

- Average tax rate of 20 valley municipalities is 2.3%
- Scottsdale's Tax Rate – 1.65% (0.65% is voter approved)
 - 1.00% - General Fund
 - 0.35% McDowell Sonoran Preserve
 - 0.20% Transportation
 - 0.10% Public Safety
 - 1.65% Total

Scottsdale Specific Information

- Resident Information (Median Family of Three)
 - Income: \$72,102
 - Estimated Annual Amount Spent on Food For Home Consumption: \$5,406
 - Estimated Annual City Paid Tax on Food For Home Consumption: \$89

Scottsdale Specific Information (continued)

- Business Information
 - 177 business licenses in the food category
 - 38 business licenses in the convenience stores (with gas)
 - 26 business licenses in the major department stores
 - 4,969 business licenses in the miscellaneous retail category

Implementation Issues to Consider

- Present proposal, notify and seek feedback of Business Community
- Businesses would need to reprogram their sales systems to charge and account for the differential rate on food sales vs. 1.65% for all other sales
- Accurate reporting could be jeopardized
- City would need to reformat system and tax returns
- Ability to purchase preserve land and/or ability to pay debt service on existing preserve debt could be impacted
- MPC debt ratios could be impacted

Revenue Impact – 3 Year Phase Out

Food Tax	FY 2015/16	FY 2016/17	FY 2017/18
General Fund - 1.00%	(\$2,431,660)	(\$4,924,112)	(\$7,514,009)
Public Safety GF - 0.10%	(236,014)	(477,928)	(751,400)
Preservation - 0.20%	(472,027)	(955,856)	(1,502,799)
Preservation - 0.15%	(354,020)	(716,891)	(1,127,099)
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Total	(\$3,965,749)	(\$8,030,642)	(\$12,398,106)

10 Year History by Category

(\$ in millions)

	Automotive	Construction	Food Stores	Hotel / Motel	Major Department Stores	Misc Retail Stores	Other Taxable Activity	Rentals	Restaurants / Bars	Utilities	License Fees, Penalties & Interest	Total for Categories
FY 04/05	24.6	28.7	9.7	7.2	12.0	22.8	9.1	17.0	10.7	6.2	2.0	150.1
FY 05/06	27.3	34.2	10.1	8.3	15.3	24.9	9.9	19.1	11.9	6.5	2.4	169.8
FY 06/07	26.8	35.3	10.3	9.2	16.9	26.4	10.0	20.6	12.8	6.9	3.0	178.2
FY 07/08	23.5	32.1	10.8	9.0	16.4	24.8	9.8	22.3	12.8	7.4	2.6	171.5
FY 08/09	15.8	22.2	10.4	7.2	14.5	19.7	10.2	20.5	11.4	7.3	2.6	141.8
FY 09/10	13.9	13.5	9.9	6.6	14.8	19.8	9.0	18.4	11.2	7.8	2.4	127.1
FY 10/11	14.5	12.7	10.2	6.9	14.6	21.2	9.2	19.2	12.0	6.9	2.2	129.7
FY 11/12	15.9	13.9	10.5	7.1	14.9	22.8	10.2	19.6	12.7	7.2	2.4	137.3
FY 12/13	18.0	14.7	10.6	7.4	15.1	23.6	11.3	20.7	13.2	7.2	2.2	144.1
FY 13/14	20.3	17.9	10.9	8.2	15.2	26.3	12.2	20.5	14.0	7.3	2.3	155.1
Minimum	13.9	12.7	9.7	6.6	12.0	19.7	9.0	17.0	10.7	6.2	2.0	127.1
Maximum	27.3	35.3	10.9	9.2	16.9	26.4	12.2	22.3	14.0	7.8	3.0	178.2
Difference	13.4	22.6	1.2	2.6	4.9	6.7	3.2	5.3	3.3	1.6	1.0	51.1

Note: Rounding differences may occur.

10 Year History by Category

% of Total Collections

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FY 05/06	16%	20%	6%	5%	9%	15%	6%	11%	7%	4%	1%	100%
FY 06/07	15%	20%	6%	5%	9%	15%	6%	12%	7%	4%	2%	100%
FY 07/08	14%	19%	6%	5%	10%	14%	6%	13%	7%	4%	2%	100%
FY 08/09	11%	16%	7%	5%	10%	14%	7%	14%	8%	5%	2%	100%
FY 09/10	11%	11%	8%	5%	12%	16%	7%	14%	9%	6%	2%	100%
FY 10/11	11%	10%	8%	5%	11%	16%	7%	15%	9%	5%	2%	100%
FY 11/12	12%	10%	8%	5%	11%	17%	7%	14%	9%	5%	2%	100%
FY 12/13	12%	10%	7%	5%	10%	16%	8%	14%	9%	5%	2%	100%
FY 13/14	13%	12%	7%	5%	10%	17%	8%	13%	9%	5%	1%	100%

Item 3

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City Council
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FY 12/13	18.0	14.7	10.6	7.4	15.1	23.6	11.3	20.7	13.2	7.2	2.2	144.1
FY 13/14	20.3	17.9	10.9	8.2	15.2	26.3	12.2	20.5	14.0	7.3	2.3	155.1
Minimum	13.9	12.7	9.7	6.6	12.0	19.7	9.0	17.0	10.7	6.2	2.0	127.1
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% of Total Collections

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FY 09/10	11%	11%	8%	5%	12%	16%	7%	14%	9%	6%	2%	100%
FY 10/11	11%	10%	8%	5%	11%	16%	7%	15%	9%	5%	2%	100%
FY 11/12	12%	10%	8%	5%	11%	17%	7%	14%	9%	5%	2%	100%
FY 12/13	12%	10%	7%	5%	10%	16%	8%	14%	9%	5%	2%	100%
FY 13/14	13%	12%	7%	5%	10%	17%	8%	13%	9%	5%	1%	100%